

# Natural Gas Contracts 101

Avoiding common mistakes in the contracting process | *Blake Baxter*

**In an environment of tight or decreasing budgets**, schools have been searching all facets of their budgets for any area where they can find savings. For years, one area that has attracted attention has been the utility bill. Many schools have upgraded their physical plants to garner greater efficiencies and lower their energy bills. Another area of interest for school officials has been to try to save money on their natural gas purchases.

In our previous article, “Understanding Today’s Natural Gas Marketplace,” (published in the August 2016 issue of *Wisconsin School News*) we discussed the natural gas supply chain and the differences between the regulated gas utilities and retail gas marketers. Building on that foundation, we will focus on the key features of natural gas contracts and how to avoid some of the common mistakes that occur in the contracting process ...

## ■ Know Your Price

Let’s get this on the table first and foremost: the most glaring mistake we find in many retail gas contracts is the lack of a definitive price. Can you look at your contract and determine what you will actually pay for your natural gas?

There are two fundamental ways to price natural gas: (1) fixed price or (2) index priced.

If you have a fixed price, then the contract should specify a price in million British thermal units (MMBtu) also referred to as Dekatherms (DTH) or Therms. As a point of reference, gas is currently trading nationally at \$2.75/MMBtu, which is \$0.275/Therm.

Fixed pricing is commonly used by those who want cost certainty, however, just remember that cost certainty can cost you dearly. Natural gas prices go both up and down and a fixed price can be either a significant loss or gain.

Indexed pricing is often used in lieu of a fixed price. Indexed pricing is the linking of your gas price to a

publicly traded price that is reported by independent news organizations. For example, your contract could state that you will pay the New York Mercantile Exchange (NYMEX) “last day settlement price” for January 2017. NYMEX pricing is reported across numerous news organizations every day and reflects the results of thousands of transactions per day.

One advantage of using NYMEX pricing is that most retail marketers or utilities will allow you to convert it to a fixed price at little to no cost. This can be important if there are changes in market conditions that make you reconsider your pricing strategy.

Another example of indexed pricing would be for your contract to state that you will pay the “first of month midpoint price” for Chicago Citygate prices as reported by Platt’s Gas Daily publication. This is a news organization that has been reporting on gas prices for decades and is depended upon by buyers and sellers across the country. Each day they report on gas trading activity at

dozens of locations from Maine to California. The advantage of this type of pricing is that it should be based on a price that is traded close to your physical location and thereby includes the majority of your transportation/basis cost.

While fixed pricing and index pricing are two popular options, these are not the only ways to price a gas contract. So how can a school official really determine if they have a contract with real gas pricing? My answer to this dilemma is to ask one simple question: “Can my district audit its gas price?” If there is any hesitation or obscurity in answering, then you may have a problem.

Additionally, make sure that the price being quoted is for delivery to your location. If your price does not include the cost of delivering the gas (a/k/a basis), then you may be in for a rather rude surprise come the next cold front.

## ■ Forecasting Usage

Another key to natural gas contracts is to understand how the contract

handles your gas usage. Just as you cannot forecast how many cell phone minutes you will use next month, very few people can forecast how much natural gas they will burn. And yet, in order to secure a definitive price for gas, you will need to supply the Retail Marketer with a forecasted gas volume.

Strategies to deal with these issues will vary, but they generally fall into two categories. The majority of consumers tend to aim low and purchase 50 to 80 percent of their expected usage. The other group tends to aim high and purchase 110 to 120 percent of their usage. Which of these strategies is the best?

The answer to that question is in your contract.

Since virtually no one can forecast their gas consumption, every contract provides a remedy for gas ordered, but not consumed, or for when the quantity ordered is less than what you consume. For large national contracts, the remedy can be that the

quantity difference is carried over to the next month. But for retail gas contracts, the retail marketer is going to charge you a price for any extra gas and it should pay you for any gas you ordered, but did not consume. How these prices are determined is the key to determining which strategy you should adopt.

It is at this point that we re-visit our earlier conversation on gas pricing. The prices paid for any variance in gas volumes should be clearly stated and should be auditable. If they are not clearly stated, then you may find in cold weather that the price you pay the retail marketer is greater than you would have paid the local gas utility. At the same time, if you do not have a distinct price for volumes that you fail to consume, you may be selling them back to the retail marketer at prices substantially below market.

The key, as you might guess, is to make sure that the prices for any variance in gas consumption are clearly stated. When these price are

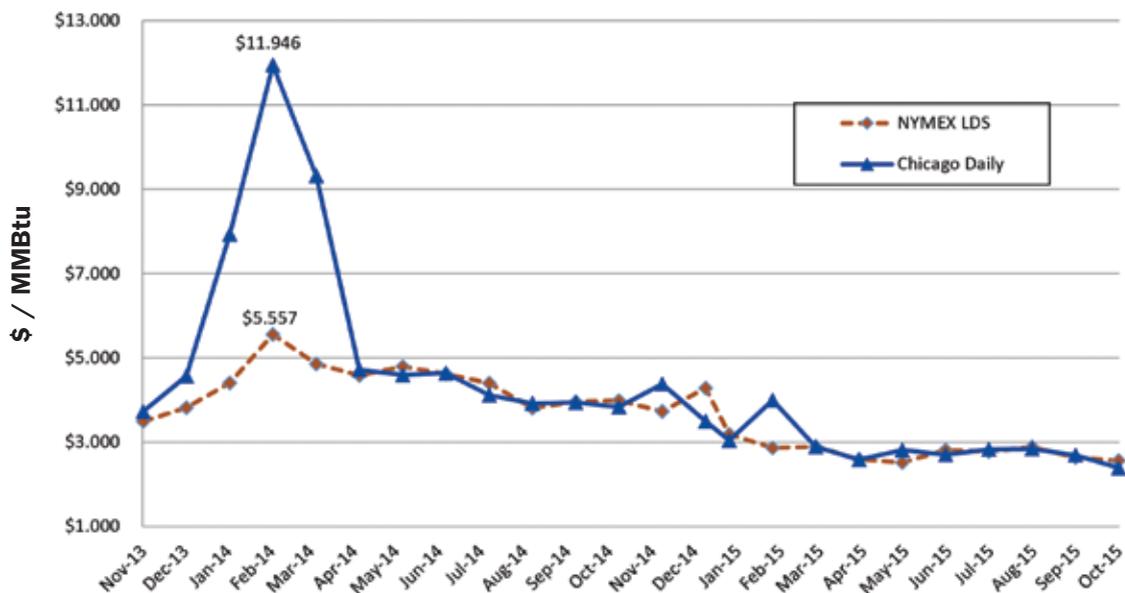
clearly stated, you can then perform the mathematical simulations necessary to determine which is the best strategy for your situation — aim high or aim low.

### ■ Perpetual Contracts

If you want some fun reading for a long winter weekend, may I suggest a copy of the Federal Acquisition Regulation or the shorter State of Wisconsin Acquisition Regulation? They are not exactly cliff hangers, but both agree on one central tenet — competition is the best way to secure value for the public. Consequently, both documents urge contracting officers to avoid perpetual agreements and provide for a number of procedural hurdles that must be met before such a contract can be signed on behalf of the government.

The central point is that when a contract has a definitive end date in a competitive marketplace, the buyer has contracting leverage. Having an end date forces the buying official to

NYMEX First of Month Pricing vs. Average Daily Chicago Pricing





## 4 THINGS YOU NEED TO KNOW About Natural Gas Contracts

**1. Price.** There are a myriad of ways to price a commodity like natural gas. The most prevalent methods are fixed price or indexed price. However, because gas pricing can take many forms it may be difficult to know which prices are derived from independent public sources and which are proprietary to a single energy company. Gas pricing derived from the New York Mercantile Exchange (“NYMEX”) is available from many sources, but does not include the cost of delivering the gas to your facility. The one question that should always be asked of any retail gas marketer is whether the price stated in the contract can be audited by your accountants.

**2. Gas Forecasting.** It is virtually impossible to forecast the gas consumption of any facility with precision. Therefore, it is critical to understand how any extra gas or any unused gas will be priced in your contract. Just like in item 1 above, the gas pricing methodology should be clearly stated and auditable. If the gas pricing is appropri-

ately stated, then the amount of gas that you should order can be derived from mathematical modeling.

**3. Perpetual Contracts.** In a competitive marketplace, the best value for any institution is realized through competition. Having a specific end date in a contract provides the buyer with significant contracting leverage. Any attempt to limit your ability to end a contract should be met with skepticism. Watch out for attempts to amend your contract through language inserted into routine transaction documents.

**3. Performance Metrics.** Natural gas purchasing is all about the numbers and the calculations are relatively simple. Never take savings for granted. Someone in your organization should be reporting on the performance of your natural gas transactions. Even if you are purchasing gas for budgetary reasons, in which case some losses may be acceptable, you should understand the metrics as part of any due diligence prior to doing more transactions.

take action and hopefully evaluate the recent performance of the contract prior to entering into a new or extended contract.

One way that the national gas industry dealt with this issue was to develop the North American Energy Standards Board (NAESB) Base Contract for the Sale and Purchase of Natural Gas. The NAESB contract is what is referred to as an enabling contract. The base NAESB contract does not contain any commercial terms and does not obligate either party to a transaction. What the base NAESB contract does is to establish a commercial relationship between a potential buyer and a potential seller that explains how transactions will be handled if the parties opt to execute a transaction. Only if and when both parties execute a transaction confirmation, as described by the NAESB contract, is there a binding commercial transaction.

This template was developed to facilitate the broader national market for gas. Large gas trading companies may have hundreds of NAESB contracts in place to facilitate high volume trading. The key is

that each transaction must have a distinct gas volume, price, location, start date and end date.

Most retail marketers will encourage buyers to sign their in-house contract, but as one saying goes, there be dragons. Retail marketers, like cell phone companies and others, draft their contracts to favor themselves. However, if pushed, most retail marketers will agree to a NAESB contract. At that point, one just needs to adhere to the KISS principal and make sure that the transaction confirmation has a distinct gas volume, price, location, start date and end date. Remember, you should avoid any language that seeks to automatically extend or perpetuate the transaction.

### ■ Metrics Revisited

In our previous article, we discussed natural gas metrics in some detail. The bottom line is that if you have entered into a good contract with a retail marketer, you should have all the information needed for you, your accountant or a consultant to evaluate the performance metrics of that natural gas transaction. The

calculations are simple enough that they could be done quickly every month, but they should be done on an annual basis at a minimum.

Unfortunately, we find too many instances of officials simply assuming that natural gas purchasing is saving them money. In some cases, this is because people compared this year’s bills with the bills from last year not realizing that gas prices have been falling in recent years (they fell to a 17-year low this past winter). In other cases, officials have opted to fix the price for budgetary reasons (in some cases for years) without a full grasp of the dollars at risk or the alternatives to managing gas price risk.

The only way to properly evaluate your gas purchasing program is to run the performance metrics. As we have previously mentioned this can be done in house or at no cost through a consultant that is well versed in the natural gas marketplace. ■

*Blake Baxter, who has more than 35 years of experience in the energy industry, is the senior energy originator for MEP Solutions, LLC located in Madison.*